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CHARLES ELMORE

No. 525

In the Supreme Court of the United States

OCTOBER TERM, 1935

GREAT WESTERN POWER COMPANY OF CALIFORNIA,
PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 35–46) is reported in 30 B. T. A. 503. The opinion of the Circuit Court of Appeals (R. 137–142) is reported in 79 F. (2d) 94.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 29, 1935. (R. 142–143.) The petition for certiorari was filed October 17, 1935,

and was granted November 18, 1935. (R. 145.) The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where the petitioner in 1924 retired certain of its bonds, known as General Lien 8's, by exchanging therefor, pursuant to the provisions thereof, an equal amount of its Series B 7 bonds and paying the agreed cash premium, may the unamortized discount and issuance expense on the General Lien 8's, plus the premium and expense incident to the exchange or substitution, be deducted in full as a loss or expense of that year, or must the aggregate of such amounts be amortized over the remaining life of the Series B 7 bonds?

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 18–19.

STATEMENT

The facts were found by the Board of Tax Appeals (R. 36–43, 46–47), in accordance with the stipulation of the parties (R. 66–132). The facts material to the issue here presented may be stated briefly as follows:

Petitioner, a California public utility corporation, kept its books in accordance with the classification of accounts prescribed by the State Rail-

road Commission, to the jurisdiction of which it was subject, and filed its income tax returns on the accrual-basis. (R. 36–37, 66.)

On March 1, 1919, the petitioner executed a Refunding Mortgage on all property then owned and thereafter acquired, to secure the payment of bonds to be issued, as directed, from time to time in any number of series the directors might determine. It was provided that the bonds of any series might be redeemed or converted or exchanged for an equal face amount of bonds of another series, at the option of the holders, as should be determined by the directors. Under this indenture the petitioner issued four series of bonds known as Series A 6%, Series B 7%, Series C 6% and Series D 5½%, all which were duly authorized by the directors. (R. 37, 66, 74–94.)

On February 1, 1921, the petitioner executed a third trust indenture (the second, known as the Mortgage Indenture, not being material here), hereinafter called the General Lien Indenture (R. 99–107), pursuant to which there were issued and sold $2,500,000 face value of General Lien 8% Gold Bonds dated February 1, 1921, and due February 1, 1936. These bonds were sold at a discount of $150,000 and the expense of issuance was $22,283.54. (R. 37–38, 67.) The General Lien Indenture provided that the bonds issued thereunder should be secured by Series B bonds, in addition to other security, deposited from time to time with the trustee, that the petitioner might redeem the Gen-

eral Lien 8's at 105 plus accrued interest at any time Series B 7's, equal in face amount to the outstanding General Lien 8's, were pledged with the trustee, and that the holders of any General Lien 8's called for redemption had the right, at their option, to receive in exchange therefor Series B 7 bonds of equal par value plus a 5% premium in cash and accrued interest. This right of conversion into Series B 7 bonds was provided for in the General Lien 8 bonds issued. (R. 99, 101–102.)

During 1921 the petitioner, pursuant to resolutions of its directors (R. 80–87), issued under the Refunding Mortgage $8,500,000 par value Series B 7 bonds, dated August 1, 1920, and due August 1, 1950, at a total expense of $49,548.14. Of these bonds $5,000,000 were pledged as security for another bond issue not here involved, $2,500,000 were deposited and pledged with the trustee under the General Lien Indenture as security for the General Lien 8 bonds, and $1,000,000 were sold to the public for cash at a discount of $100,000. (R. 39, 68–69.)

Prior to December 31, 1923, the petitioner purchased and retired $11,000 face value of the General Lien 8 bonds and charged off as a loss of that year the unamortized discount and issuance expense applicable thereto. (R. 38, 67.)

On August 1, 1924, pursuant to a resolution of petitioner's directors, the holders of $2,354,500 par value General Lien 8 bonds exchanged the same, in accordance with the provisions of such bonds and of the General Lien Indenture, for a like amount

of Series B 7 bonds and in addition thereto a cash premium of $117,725. The unamortized discount and expense of issuance applicable to the converted bonds amounted on August 1, 1924, to $126,176.97, and the expense of conversion was $1,461.05. The unamortized discount and expense applicable to the General Lien 8's converted, the premiums thereon, and the expense of conversion aggregated $245,-363.02. The balance of General Lien 8's outstanding, face value $134,500, were purchased for cash and retired by the petitioner as of August 1, 1924, at an aggregate expense of $14,016.28, representing a premium of $6,725 plus unamortized discount and expense of $7,207.82 plus retirement expense of $83.46. (R. 38–39, 67–68.) All Series B 7 bonds not exchanged for General Lien 8 (or other) bonds were returned to the petitioner by the trustees of the several indentures with whom deposited and were not thereafter reissued. (R. 39, 40, 69.)

In addition to a deduction for unamortized discount and issuance expense, premiums and retirement expense on General Lien 8 bonds retired in 1924 for cash, which is admittedly allowable (R. 43–44), the petitioner claimed a deduction in 1924 for unamortized discount and issuance expense, premiums and retirement expense, aggregating $245,363.02, on the General Lien 8 bonds converted into or exchanged for Series B 7 bonds. This amount was not charged to profit and loss on petitioner's books, but was transferred to the Series B account to be amortized over the remaining life

of the Series B 7 bonds. The respondent denied the deduction of the latter amount in full in 1924, on the ground that it should be amortized over the life of the Series B 7 bonds substituted for the General Lien 8's, and allowed a deduction on account thereof in 1924 of $2,027.96. (R. 38, 43, 68, 74.)

The Board of Tax Appeals sustained the claim of the petitioner and allowed a deduction for 1924 of the full amount of unamortized discount and issuance expense, premiums and retirement expense on the General Lien 8 bonds exchanged for Series B 7 bonds. (R. 45–46.) The Circuit Court of Appeals reversed the decision of the Board and, sustaining the respondent, disallowed the deduction. (R. 142.)

SUMMARY OF ARGUMENT

Discount, premium and expense incident to an issue of bonds, and the retirement thereof, are all items of the cost of the use of the money. The amount of such items is not deductible in the year of issuance. The loss or expense represented by such cost is not sustained or incurred until the bonds are paid at maturity. Under the statute, however, as interpreted by the Treasury Regulations the cost may be amortized and a proportionate amount deducted annually during the life of the bonds. But the annual deduction of amortized discount, and other expenses, is allowed only by way of anticipation of actual payment of the bonds at maturity.

Here, the General Lien 8's in question were not paid at maturity, but prior to maturity they were exchanged for Series B 7 bonds of equal amount pursuant to the terms of the General Lien 8's. The old bonds were not paid and the indebtedness was not retired in the taxable year in question (1924). There was nothing more than a substitution of the Series B 7 bonds for the General Lien 8's, as provided for upon the issuance of the latter, and the debt remained, there being only a change in the paper evidence of the indebtedness. The money obtained from the original bonds was not repaid, but was retained by the taxpayer who continued to use it. Hence, the amount of the unamortized discount and expense, plus the premium and retirement expense, applicable to the exchanged bonds was not a sustained or realized loss or expense in the year of the exchange, but represented the cost of the use of the money for the period of the new bonds which must be amortized over the life of such bonds.

ARGUMENT

THE UNAMORTIZED DISCOUNT AND EXPENSE APPLICABLE TO BONDS EXCHANGED, PURSUANT TO THEIR PROVISIONS, FOR OTHER BONDS, TOGETHER WITH THE PREMIUM PAID AND EXPENSE OF EXCHANGE, SHOULD BE AMORTIZED OVER THE LIFE OF THE NEW BONDS AND NOT DEDUCTED IN FULL IN YEAR OF SUBSTITUTION

The petitioner seeks to deduct from its income in 1924 the full amount of the unamortized discount and expense of issuance, together with the premium and retirement expense paid, on its bonds con-

verted in that year, in accordance with their terms, into its bonds of another class. The Circuit Court of Appeals held that upon the substitution of the new bonds for the old there was only a change in the form of the obligation, the debt remaining to the extent of the face value of the substituted bonds, and that the petitioner received for the substituted bonds the net amount it had received for the old bonds less the expense of issuing the new and the additional expense of retiring the old. The unamortized discount and issuance expense of the old bonds, plus the premiums and retirement expense, represents the discount on and expense of issuing the new bonds and hence the aggregate of such amounts may not be deducted in full in the year of substitution, but must be amortized over the life of the new bonds and an aliquot part only deducted in each year. We submit that the decision below is correct.

Discount, premium, and expense incident to a bond issue are factors in arriving at the actual amount of interest paid for the use of the capital thereby procured. *Helvering* v. *Union Pacific Co.*, 293 U. S. 282, 286. A portion of each of the items is therefore attributable to each year of the life of the bonds, and that portion only is deductible each year.

There is no specific provision in the law which permits this amortization.[1] However, the statute,

[1] The regulations provide for the amortization of discount but make no specific reference to premium and expense. Article 545, Regulations 65, *infra* p. 18. See *Helvering* v. *Union Pacific Co.*, 293 U. S. 282, 284–285.

by authorizing returns on the accrual basis enables taxpayers to charge against the income of a taxable period expenses incurred in and properly attributable to the process of earning income during that period, even though payment is made in a later one. *United States* v. *Anderson,* 269 U. S. 422, 440; *Aluminum Castings Co.* v. *Routzahn,* 282 U. S. 92; *Niles Bement Pond Co.* v. *United States,* 281 U. S. 357. It is under this provision that expenses or obligations incurred in connection with a bond issue, which are not discharged until the payment of the bonds at maturity, may be properly amortized over the life of the bonds and allowed as annual deductions from gross income. *Helvering* v. *Union Pacific Co., supra.*

Amortized discount is deductible from the taxpayer's income only by way of anticipation of payment of the bonds at maturity. *Old Mission Co.* v. *Helvering,* 293 U. S. 289. It would seem to follow that amortized premium and expense are deductible only upon the same anticipation. As the Court stated in *Helvering* v. *Union Pacific Co., supra* (pp. 286–287):

> Both commissions and discount, as the Government concedes, are factors in arriving at the actual amount of interest paid for the use of capital procured by a bond issue. The difference between the capital realized by the issue and par value, which is to be paid at maturity, must be added to the aggregate coupon payments in order to arrive at the

> total interest paid. Both discount and commissions are included in this difference. If the difference be viewed as a loss resulting from the funding operation, it is one which is realized only upon the payment of the bonds at maturity.
>
> * * * * *
>
> They come out of the pocket of the taxpayer only on payment of the bonds at maturity.

But the bonds in the instant case were not paid at maturity. Before maturity petitioner merely substituted its new bonds to evidence the indebtedness. The exchange was made under the terms of the old bonds. The discoun had no more been paid after the issuance of the new bonds than it had been paid when the old bonds were issued. There remained the same obligation—a promise to pay—and the discount, premium and expense paid were properly chargeable to capital as representing a part of the cost of the use of capital during each year of the life of the new bond issue. Cf. *Helvering* v. *Union Pacific Co., supra;* cf. *United States* v. *Anderson, supra.*

No loss has been realized. Unlike the case of *United States* v. *Kirby Lumber Co.,* 284 U. S. 1, wherein the taxpayer actually purchased its bonds and on the net transaction had received more cash than it had paid for each bond, in the instant case the petitioner was still indebted to the holders of the old bonds (with whom the new bonds were exchanged) under and by virtue of the terms of the

old bonds, for the substitution of the new bonds for the old was a part of the original contract. After the issuance of the new bonds the same creditors remained, possessing no more than new evidences of the same debt. And the payment of the premiums pursuant to the terms of the trust instrument was just as much a discount attached to the Series B bonds as was the original discount attaching to the General Lien 8's.

The petitioner contends that the exchange "purchased and retired" the original bonds within the meaning of Article 545 of Regulations 65, *infra*, p. 18. Such a construction is not only contrary to that placed upon it by the Commissioner, but is opposed to the clear intent of the article—to treat premium, discount and expense as part of the cost of the use of capital (part of the actual interest paid) and to spread such cost ratably over the period of the indebtedness. In the instant case the Series B 7's were issued at the same time and as a part of the transaction pursuant to which the General Lien 8's were issued. The Series B 7's were placed in the hands of a trustee for the purpose of substitution for such of the General Lien 8's as to which the holders exercised their option to exchange. Clearly, there was no retirement of the original bonds within the meaning of the regulations. The debt evidenced by the old bonds was not paid and retired. The exchange merely effected a change in the paper evidence of the indebtedness

and did not terminate it in any sense. It therefore did not definitely fix the unamortized discount on August 1, 1924, as a part of the cost of the use of the money up to that date. The capital obtained by the issue of the old bonds was not returned at that time. The money, under and by virtue of the terms of the original contract, was to be, and was, used for a further period. The discount, premium, and expense are a part of the cost of its use for that further period. This fact was recognized by the State Railroad Commission as reflected by the books of the taxpayer, wherein the three items were transferred to "Discount and Expense Series B Account General Lien" to be amortized over the remaining life of the Series B 7's. (R. 66, 74.)

Helvering v. *Central States Electric Corp.*, 76 F. (2d) 1011 (C. C. A. 2d); *Helvering* v. *Union Public Service Co.*, 75 F. (2d) 723 (C. C. A. 8th); *Helvering* v. *California Oregon Power Co.*, 75 F. (2d) 644 (App. D. C.), are not opposed to the decision below and the views herein advanced. In each of those cases an outstanding bond issue was retired before maturity by payment in cash obtained from the separate sale of a new bond issue, which was unrelated to the earlier issue. In each case it was specially noted that there was no exchange or substitution of the new bonds for the old and that there was no interrelation or continuity of transactions, the retirement of the old bonds and the issuance of the new being wholly separate transactions. Ac-

cordingly, it was held that the unamortized discount and expense of the old issue, together with the premium and expense on retirement, were a deductible expense or loss in the year of retirement under the regulations. In the instant case the retirement of the General Lien 8's and the issuance of the Series B 7's, here involved, were directly interrelated and were in substance one continuing transaction.[2] The Series B 7's were merely exchanged or substituted for the General Lien 8's in accordance with the terms and conditions under which the latter were issued. Accordingly, the retirement of the General Lien 8's by substitution of Series B 7's therefor was not a completion of the transaction initiated by the issuance of the General Lien 8's.

Nor is *Commissioner* v. *Coastwise Transp. Corp.*, 62 F. (2d) 332, 71 F. (2d) 104 (C. C. A. 1st), inconsistent with the contention here made. There it was held that, upon the retirement of notes, representing the purchase price of property, by the issuance of bonds in exchange therefor, the face amount of the notes in excess of the par value of the bonds was taxable income. The exchange was not pursuant to the terms under which the notes were issued, but was an unrelated voluntary agreement subsequently entered into, and by that sub-

[2] To the extent that the General Lien 8's were retired for cash it has been conceded that the unamortized discount and expense, the premium and retirement expense, applicable thereto are a deductible loss or expense in the year of retirement.

sequent independent transaction the taxpayer reduced its indebtedness so that the transaction initiated by issuance of the notes was then completed, resulting in the acquisition of property or capital which would cost it no more than the face value of the bonds. There was no like completion of the transaction here, through a subsequent unrelated deal, resulting in a decrease of indebtedness.

In *San Joaquin Light & Power Corp.* v. *McLaughlin,* 65 F. (2d) 677 (C. C. A. 9th), it was held that upon the retirement of bonds of one issue, in part by the payment of cash and in part by an exchange of bonds of another issue pursuant to the provisions of the earlier issue, the amount of unamortized discount and expense, plus the premium and retirement expense, applicable to the old bonds, those exchanged for new as well as those retired for cash, is a deductible expense or loss in the year of retirement. So far as that case holds that the discount, premium and expense applicable to the exchanged bonds were a deductible loss or expense in the year of the exchange it is directly contrary to the decision of the lower court in the present case, and, we submit, is erroneous.[8] The correct view regarding the exchanged bonds we think is expressed in that case by Judge Mack, dissenting (pp. 681–682):

> The situation, however, as to the C bonds is, in my judgment, entirely different.

[8] See comment in 47 Harvard Law Review, pages 1260–1261.

Those D bondholders who made the exchange exercised a right that had been created when the D bonds were issued. The C bonds were issued at the same time for the very purpose of being substituted if the holders should exercise their option. When the exchange was made in 1922, the indebtedness originally created and evidenced by the 1492 D bonds was in no sense paid; its form was merely changed by an extension of the maturity, a decrease in the interest rate, in form to 6 per cent.; in substance, however, to a somewhat higher rate represented by the $40 cash premium, and the $10 cash discount paid at the time.

In my judgment, neither the unamortized part nor the premium was any more a loss to the company for the year 1922 than was the $10 discount. As appellee contends, this unamortized portion was in 1922 just what it was in 1920—a prospective, but not a realized, loss. It would become an actual loss only if and when appellant actually paid off and retired the bonds at par. The substitution of the new bonds pursuant to the original contract is not, however, a payment of the debt; the debt remains. One document has merely been substituted for another as evidence of it.

I concur, too, fully, in appellee's argument that the payment of the $50 in 1922, pursuant to the terms under which the original indebtedness was created in 1920, is just as much a discount attaching to the C bond as the original $70 was a discount attaching to the D bond.

It must be remembered that the discount, premium, and expense incident to an issue of bonds represent the cost of the use of the money, which is paid upon the maturity and payment of the bonds. No loss or expense is suffered or incurred until the bonds are paid in an amount in excess of the net proceeds obtained from the issuance, and the annual deduction of proportionate amounts of such cost is allowed only by way of anticipation of the actual payment of the bonds. With a due regard for this established principle, it seems clear that when the bonds are not paid but are exchanged for other bonds of equal amount, which are substituted for the old bonds in accordance with their terms, the amount of the unamortized discount and expense, plus the premium and retirement expense, applicable to the exchanged bonds is not a sustained loss or incurred expense in the year of the exchange. It might well be that upon the final payment and retirement of the indebtedness a gain, rather than a loss, will be realized. The statute is concerned only with realized losses, as with realized gains. *Weiss* v. *Wiener,* 279 U. S. 333.

It may be added that the petitioner was required by the State Railroad Commission to keep its books on the basis upon which the Commissioner has made his determination. Much latitude for discretion is given the Commissioner charged with the duty of enforcing the Act. Even where his determination is not in accordance with the method of ac-

counting employed by the taxpayer, his interpretation of the statute and the practice adopted by him should not be interfered with unless clearly unlawful. *Lucas* v. *American Code Co.*, 280 U. S. 445. *A fortiori* the Commissioner's determination should not be disturbed when in accordance with the method upon which taxpayer was required to keep its books, unless it be most clearly in conflict with the law.

CONCLUSION

The decision of the court below is correct and should be affirmed.

Respectfully submitted.

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FEBRUARY 1936.

APPENDIX

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1924, c. 234, 43 Stat. 253:

> SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *;
>
> (2) All interest paid or accrued within the taxable year on its indebtedness, * * *
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise. * * *.

Treasury Regulations 65:

> ART. 545. *Sale and retirement of corporate bonds.*—* * *
>
> (3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. (*c*) If, how-

ever, the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year.

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